SUTHERLAND

SUTHERLAND ASBILL & BRENNAN LLP
700 Sixth Street, NW, Suite 700
Washington, DC 20001-3980
202.383.0100 Fax 202.637.3593
www.sutherland.com

March 22, 2013

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

VIA ELECTRONIC MAIL

International Organization of Securities Commissions
C/ Oquendo 12
28006 Madrid
Spain

Re: *Second Consultative Document: Margin Requirements for Non-Centrally Cleared Derivatives*

To Whom It May Concern:

On behalf of The Commercial Energy Working Group (the "**Working Group**"), Sutherland Asbill & Brennan LLP hereby submits these comments in response to the Second Consultative Document on Margin Requirements for Non-Cleared Derivatives (the "**Second Consultative Document**") issued by the Basel Committee on Banking Supervision (the "**Basel Committee**" or "**BCBS**") and the Board of the International Organization of Securities Commissions ("**IOSCO**") on February 15, 2013.[1] The Working Group appreciates the opportunity to provide the comments set forth herein and respectfully requests the Basel Committee's and IOSCO's respective consideration of such comments.

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial, and residential consumers. Members of the Working Group are energy producers, marketers, and utilities. The Working Group considers and responds to requests for comment regarding regulatory and legislative developments in the United States and internationally with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

As commercial energy firms predominantly transacting in swaps that fall under the jurisdiction of the United States Commodity Futures Trading Commission (the "**CFTC**"), the Working Group submits this comment letter in recognition that the CFTC may support the final margin framework of the Basel Committee and IOSCO, and adopt a close approximation of the

---

[1] Available at: www.bis.org/publ/bcbs242.pdf.

international model. Thus, the Working Group seeks to ensure that the BCBS and IOSCO knowingly avoid any unforeseen consequences of the Second Consultative Document for the entire derivatives marketplace.

I. Comments of the Working Group.

1. *The Working Group Supports Limiting Margin Requirements to "Financial Firms" and "Systemically Important Non-Financial Firms," Subject to the Proper Classification by United States Regulators.*

The Working Group supports the application of the Basel Committee and IOSCO margin framework for uncleared derivatives solely to financial firms and systemically-important non-financial entities (each, a "**Covered Entity**"). This tailored approach, rather than applying the framework more generically to regulated entities trading with commercial firms creates more certainty and appropriately targets the most systemically risky entities.

As noted in the Second Consultative Document, "the appropriate definition of financial firms, non-financial firms and systemically-important non-financial firms will be determined by appropriate national regulation." While the Working Group supports the decentralized classification of each of these types of entities, we urge the Basel Committee and IOSCO to clarify that its margin framework for uncleared derivatives is designed solely for *financial enterprises*, not entities within non-financial enterprises that happen to conduct financial activity (*e.g.*, a central hedging entity).

There is some concern in the United States that commercial entities trading physical commodities may get swept into the federal regulators' definition of the term "financial entity," and this unintended consequence may create prohibitive regulatory expenses for commercial entities that were never intended to be regulated like banks and other systemically-important firms. As such, additional clarity on the term "Covered Entity" carving out non-financial enterprises that conduct some financial activity would be a welcome modification to the Second Consultative Document.

2. *The Working Group Supports the Proposed Phase-In Timeline for Margin Requirements.*

The Working Group supports the phase-in timeline proposed by the Basel Committee and IOSCO in the Second Consultative Document, and believes that the timeline is an appropriate tool for allowing the market to adapt to the new margin framework. Adhering to increased margin requirements for uncleared derivatives may require substantial amounts of capital as well as significant operational modifications. As such, providing ample notice to affected market participants and requiring compliance for entities with the largest average notional amounts of uncleared derivatives first is an apposite means of transitioning the uncleared derivatives marketplace to a new margin framework.

3. The Working Group Supports the Basel Committee and IOSCO's Proposed List of Acceptable Collateral.

In Element Four of the Second Consultative Document, the Basel Committee and IOSCO propose a (non-exhaustive) list of eligible collateral for Covered Entities to use in meeting their margin requirements. The Working Group supports the inclusion of this list in the final margin framework for uncleared derivatives, to the extent that it applies solely to financial enterprises. This is to say that the Working Group believes that the BCBS and IOSCO proposed list of eligible collateral is appropriate, so long as national regulators do not propose to apply margin requirements when regulated entities trade with commercial firms.

If national regulators do adopt broader proposals, the Working Group would urge the Basel Committee and IOSCO, as well as the relevant regulators, to expand the list of eligible collateral to meet margin obligations to a more extensive range of non-cash collateral. Such collateral might include, among other things, liens on fixed assets and letters of credit. As stated by two United States legislators: "individual credit arrangements worked out between counterparties in a bilateral transaction can be important components of business risk management."[2] If required to post collateral for uncleared derivatives, which the Working Group does not support, the use of non-cash collateral by non-financial enterprises would allow these entities to engage in necessary business practices like hedging, while making allowances for any corporate structure and unique liquidity constraints, which are vital to commercial entities.

4. The Working Group Urges the Basel Committee and IOSCO To Decrease the Standardized Initial Margin Requirement for Uncleared Commodity Derivatives.

In Appendix A to the Second Consultative Document, the Basel Committee and IOSCO set forth a standardized initial margin schedule, ranging from 1-15% of notional exposure by asset class and in some cases by duration of the transaction. The Working Group is particularly concerned with the 15% initial margin requirement for commodity derivatives, which is substantially higher than most of the other asset classes for no specified reason. The Working Group does not believe that this initial margin requirement is an accurate reflection of the normal potential future price movement over a defined time for any given derivative. Nor does the initial margin requirement reflect the divergent price movement characteristics of several different commodities across agriculture, metals, soft and energy commodities.

More importantly, Working Group members are concerned that under this framework, if a commercial energy firm was to transact with a Covered Entity counterparty, the counterparty may then hedge the transaction with another Covered Entity counterparty, and may pass through the ensuing higher margin requirements on to the commercial energy firm (and other non-financial, commercial counterparties) in order to absorb the added cost and avoid asymmetry. This would be a detrimental and unintended consequence of implementing a standardized initial

---

[2] *See* Letter from Sen. Dodd, Chairman, Committee on Banking, Housing, and Urban Affairs, and Sen. Lincoln, Chairman, Committee on Agriculture, Nutrition, and Forestry to Rep. Frank, Chairman, Committee on Financial Services, and Rep. Peterson, Chairman, Committee on Agriculture (June 30, 2010).

margin requirement as high as 15% of notional exposure, and as such the Working Group respectfully requests that the BCBS and IOSCO decrease this percentage.

5. *The Working Group Supports Exempting Physically-Settled FX Forwards and FX Swaps From Margin Requirements.*

The Working Group urges the Basel Committee and IOSCO to exclude foreign exchange swaps ("**FX swaps**") and physically-settled foreign exchange transactions ("**FX Forwards**") from its margin framework for uncleared derivatives. Generally speaking, these two kinds of transactions have fixed payment obligations, are settled by the physical exchange of actual currency, are predominantly short-term instruments (98% mature in less than one year and 68% mature in less than one week), trade in highly transparent and liquid markets, and are commonly used as a source of funding the hedge risk associated with short-term fluctuations in foreign currency values and to manage global cash-flow needs. Because they are physical settling and predominantly used for risk mitigating purposes, FX forwards and FX swaps should be exempted from both initial margin and variation margin requirements.

In the United States, the Department of the Treasury (the "**U.S. Treasury**") issued a determination exempting both of these kinds of transactions from being regulated as "swaps."[3] Essentially, the U.S. Treasury views these transactions as physically settling contracts requiring lighter regulation, particularly in light of the fact that they involve the actual exchange of the principal amounts of two currencies that are fixed at a contract's inception and are known throughout the life of the contract. The Working Group agrees with the U.S. Treasury analysis and conclusions that FX forwards and FX swaps are physically-settling, and should not be subject to margin requirements, regardless of the maturities of the contracts.

6. *The Working Group Urges the Basel Committee and IOSCO to Require Counterparty Access to Internal Models, Upon Request.*

In the Second Consultative Document, the use of internal or third-party quantitative models for calculating initial margin must be approved by the relevant supervisory authority, within each jurisdiction and by each entity seeking to use the model. The Working Group generally supports this process. However, the Working Group respectfully requests that the Basel Committee and IOSCO include in their final margin framework a requirement that derivative counterparties relying on internal models provide their counterparties, upon request, with access to the model that will be used to assign initial margin requirements.[4] It is necessary for derivatives counterparties to have such access to adequately anticipate their working capital

---

[3] *See Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act*, Final Determination, 77 Fed. Reg. 69,694 (Nov. 20, 2012), available at http://www.gpo.gov/fdsys/pkg/FR-2012-11-20/pdf/2012-28319.pdf.

[4] The Working Group notes that access to the model would not include access into the model-using counterparty's credit determination regarding the requesting counterparty. The credit determination should be made separate and apart from the analysis of the amount of initial margin necessary to account for the risk associated with a particular swap. In other words, a counterparty using internal models should make a transparent determination as to the initial margin required to cover the risk inherent in the derivative contract in question and should then increase that amount by an agreed upon percentage to account for the credit risk posed by the other counterparty.

needs. Such transparency will also allow counterparties to make more informed choices as to their preferred trading counterparties and allow them to monitor and dispute initial margin calculations if they prove to be contrary to agreed-upon terms.

7. *The Working Group Urges the Basel Committee and IOSCO to Affirmatively State that Affiliated Entities Need Not Exchange Initial or Variation Margin for Uncleared Derivatives.*

In the Second Consultative Document, the Basel Committee and IOSCO acknowledge that "the exchange of initial or variation margin by affiliated parties to a non-centrally cleared derivative is not customary," and that creating initial margin requirements for such transactions would "likely create additional liquidity demands for firms engaging in such transactions." Although the regulatory treatment of inter-affiliate transactions varies by jurisdiction, the Working Group exhorts the BCBS and IOSCO to affirmatively state that the exchange of initial or variation margin is not required for affiliated entities that transact in derivatives.

Many entities use inter-affiliate derivatives as a means of managing risk and transferring exposures between affiliates, and they enter into these transactions for any number of reasons, including compliance with international tax laws, compliance with customs obligations, or to ensure that internal accounting obligations are properly reflected amongst affiliated entities. Imposing margin requirements on these transactions stands to introduce unnecessary restrictions on inter-affiliate relationships. Further, if variation margin must be passed among affiliates, such practice may represent inefficient use of cash resources among the enterprise and may come at meaningful financing costs. These costs may lessen a commercial enterprise's ability to use its resource on other legitimate business purposes, including capital expenditures and job creation.

For these reasons, the Basel Committee and IOSCO should not leave margin requirements for uncleared swaps between affiliated entities to the discretion of each jurisdiction. Instead, the BCBS and IOSCO final margin framework should explicitly state that the exchange of margin is not required between affiliated entities that enter into inter-affiliate derivatives.

II. <u>CONCLUSION</u>.

The Working Group supports appropriate regulation that brings transparency and stability to the swap markets worldwide. The Working Group appreciates this opportunity to provide comments on the Second Consultative Document and respectfully requests that the Basel Committee and IOSCO consider the comments set forth herein as they develop their final framework on margin requirements for uncleared derivatives.

If you have any questions, please contact the undersigned.

Respectfully submitted,

<u>/s/ David T. McIndoe</u>

David T. McIndoe
Alexander S. Holtan
Cheryl I. Aaron

Counsel for The Commercial Energy Working Group

cc: Gary Gensler, Chairman, Commodity Futures Trading Commission

Elisse B. Walter, Chairman, Securities and Exchange Commission

Office of the Comptroller of the Currency, Department of the Treasury

Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System

Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation

Gary K. Van Meter, Director, Office of Regulatory Policy, Farm Credit Administration

Alfred M. Pollard, General Counsel, Federal Housing Finance Agency